



DEPARTMENT OF DEFENSE

JOINT AUDIT REPORT

DIRECT VENDOR DELIVERY AND JUST-IN-TIME INVENTORY MANAGEMENT INITIATIVES

Report No. 97-220

September 24, 1997

19991012 184

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Acronyms

DLA
DVD
GAO
TACOM

Defense Logistics Agency
Direct Vendor Delivery
General Accounting Office
Tank-automotive and Armaments Command



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September 24, 1997

MEMORANDUM FOR DEPUTY UNDER SECRETARY OF DEFENSE FOR
LOGISTICS
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE LOGISTICS AGENCY
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Audit Report on Direct Vendor Delivery and Just-in-Time Inventory
Management Initiatives (Report No. 97-220)

We are providing this audit report for information and use. This audit was requested by the Joint Logistics Commanders and was performed as a joint audit effort by the Army Audit Agency, the Naval Audit Service, the Air Force Audit Agency, and the Inspector General, DoD. Because this report contains no findings or recommendations, no written comments were required, and none were received.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. John A. Gannon, Audit Program Director, at (703) 604-9176 (DSN 664-9176) or Mr. Walter R. Loder, Audit Project Manager, at (703) 604-8840 (DSN 664-8840). See Appendix D for the report distribution. The audit team members are listed inside the back cover.

Shelton R. Young
for Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 97-220
(Project No. 7LD-5026)

September 24, 1997

Direct Vendor Delivery and Just-in-Time Inventory Management Initiatives

Executive Summary

Introduction. This audit was requested by the Joint Logistics Commanders and was performed as a joint audit effort by the Army Audit Agency; the Naval Audit Service; the Air Force Audit Agency; and the Inspector General, DoD, under the auspices of the Joint Logistics Audit Planning Group. Congress required DoD to adopt the industry's best commercial inventory management practices to manage its inventory, including direct vendor and just-in-time inventory deliveries to DoD customers. During FY 1996, DoD managed about 3 percent of its reported \$68.5 billion inventory using direct vendor delivery and other commercial inventory management techniques.

Audit Objectives. The objective of the audit was to determine whether Defense organizations computed savings from direct vendor delivery and just-in-time inventory management initiatives in accordance with the DoD Materiel Management Regulation. We also reviewed the reasonableness of the methodology used in the calculation of estimated cost savings.

Audit Results. The Military Departments and the Defense Logistics Agency computed savings for direct vendor and just-in-time delivery inventory management initiatives in accordance with the DoD Materiel Management Regulation. Also, the Military Departments and the Defense Logistics Agency used reasonable methodologies to compute savings.

Management Comments. We provided a draft of this report on July 2, 1997. Because this report contains no findings or recommendations, written comments were not required, and none were received. Therefore, we are publishing this report in final form.

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Part I - Audit Results

Audit Background

This audit was requested by the Joint Logistics Commanders and was performed as a joint audit effort by the Army Audit Agency; the Naval Audit Service; the Air Force Audit Agency; and the Inspector General, DoD, under the auspices of the Joint Logistics Audit Planning Group. The Joint Logistics Commanders asked the DoD internal audit community to review the methodologies used to calculate savings resulting from using direct vendor delivery (DVD) and just-in-time inventory management techniques*. Congress required DoD to adopt the industry's best commercial inventory management practices, including DVD, to support DoD customers. The purpose of implementing best commercial inventory management practices is to improve the quality of the products, accelerate response time, and decrease cost. During FY 1996, DoD managed about 3 percent of its reported \$68.5 billion inventory using DVD and other commercial inventory management practices.

DoD is concerned about reducing the costs of storing and handling equipment and material as part of its overall plans to streamline logistics functions. In particular, costs of buying and storing inventory are a major concern of DoD management. Those costs include the purchase price of inventory, second destination transportation charges, interest cost to the Government, and the costs of storage, including employee handling and storage space. By using DVD, the costs of transporting, storing, and handling equipment and material are reduced through direct delivery of items from the vendor to DoD customers.

DoD has major efforts underway to streamline inventory management, including adopting commercial inventory management practices. For example, the Defense Logistics Agency (DLA) has applied DVD through a technique called the Prime Vendor Program at the Defense Personnel Support Center, Philadelphia, Pennsylvania, for medical and pharmaceutical items, as well as subsistence items. Under the program, the inventory of medical and pharmaceutical items is owned by a distributor who fills requisitions from DoD customers and supplies the requested items directly to them. DoD hires a contractor to manage its supply needs. The Army, the Navy, and the Air Force also have pilot programs to adopt other commercial inventory management practices for inventory management. The pilot programs cover a variety of commercial inventory management practices and are designed to address specific inventory management problems of each of the Military Departments. For example, the Army Communications and Electronics Command is planning to manage radio batteries using DVD techniques. The DLA adoption of commercial inventory management practices and the Army, Navy, and Air Force pilot programs could lead to viable, long term solutions to some of the DoD problems associated with the storage and handling of equipment and material.

*For the purposes of our report, DVD is used to denote both inventory management techniques.

Audit Objectives

The objective of the audit was to determine whether DoD computed savings from DVD and just-in-time inventory management initiatives in accordance with the DoD Materiel Management Regulation. We also reviewed the reasonableness of the methodology used in the calculation of estimated cost savings. Appendix A describes the audit process, and Appendix B discusses prior audit reports.

Savings From Inventory Management Initiatives

The Military Departments and the DLA computed savings for direct vendor and just-in-time delivery inventory management initiatives in accordance with the DoD Materiel Management Regulation. Also, the Military Departments and the DLA used reasonable methodologies to compute savings. The requirement for computing savings should not be an impediment for expanding the use of direct vendor and just-in-time delivery inventory management initiatives.

Guidance

Implementation of DVD inventory management initiatives and calculations of savings were based on the following guidance.

National Defense Authorization Act for Fiscal Year 1996. The National Defense Authorization Act for Fiscal Year 1996, Public Law 104-106, Section 352, (see Title 10, United States Code, Section 2458 note) requires DoD to implement a system under which vendors deliver consumable inventory items directly to military installations throughout the United States. The purpose for implementing that system is to reduce the expense and necessity of maintaining extensive warehouses for those items within DoD. Items specifically included in the law are automotive, construction, and electrical supplies; food and clothing; fuel; medical and pharmaceutical supplies; and other appropriate consumable inventory items.

DoD Regulation. DoD Regulation 4140.1-R, "DoD Materiel Management Regulation," January 1993, states that DoD should maximize the use of commercial distribution systems as an alternative to storing items at DoD wholesale and retail levels. Each organization has the authority and flexibility to implement practices best suited to its needs. At the wholesale level, DoD should employ direct delivery from vendor to user whenever direct delivery is cost-effective and responsive to user requirements. The regulation requires that DoD organizations perform market research to identify alternatives to DoD storing items, such as using commercial distribution systems and using commercial products instead of military specification products. The regulation also requires DoD organizations to perform cost-benefit analyses and to periodically review cost-benefit analyses to ensure the use of updated cost factors. DoD organizations are to include all applicable elements of cost to determine cost savings, such as inventory holding costs, second destination transportation charges, shelf-life and offsetting cost such as increased unit price.

Savings Calculations

The savings methodologies that the Military Departments and the DLA used to calculate cost savings complied with DoD Regulation 4140.1-R. The regulation requires that selected factors be considered, but does not formalize the specific methodology to be used. The methodologies reviewed were reasonable.

Flexibility. DoD Regulation 4140.1-R strongly encourages the Department to expand the use of DVD and other initiatives, recognizing that savings will accrue. The Department wants to emulate best business practices by adopting DVD and other initiatives. The savings have been well documented by industry. Rather than require a detailed and time-consuming process to justify the inventory initiatives, the regulation was written to provide a rudimentary framework for identifying potential savings, with provisions for refining the factors used, so that various initiatives could be timely implemented.

Savings Methodologies. The DLA, the Army, the Navy and the Air Force were using various methods of calculating cost savings. The methods included computer cost modeling, management analysis, and estimates that contractors prepared. The methods used were reasonable and complied with DoD Regulation 4140.1-R.

Headquarters, Defense Logistics Agency. For hardware national stock numbers, such as automotive parts, and groups of national stock numbers, Headquarters, DLA, developed a computer cost model, called the Method of Support Model, to determine the feasibility of using DVD. The model included various cost factors including acquisition lead time changes, holding cost, transportation and offsetting price increases. The model was reasonable and complied with DoD Regulation 4140.1-R. The model focused on computing cost savings for the wholesale level organization procuring hardware commodities.

Defense Personnel Support Center. The Defense Personnel Support Center, a component of DLA, estimated savings for medical and pharmaceutical items as well as subsistence items. The Defense Personnel Support Center is the inventory manager for more than \$1 billion of clothing; textiles; and medical, pharmaceutical, and subsistence items. The methods for estimating savings were acceptable and complied with DoD Regulation 4140.1-R.

Medical and Pharmaceutical Items. The Defense Personnel Support Center identified over \$30 million in estimated savings annually from adopting prime vendor practices in procuring medical and pharmaceutical items. The estimates were based on overall inventory and support cost reductions at the wholesale level, including depot storage costs, item price reductions, and personnel. As a result of the Prime Vendor Program, the Defense Personnel Support Center reduced inventories of those items by more than \$200 million from FYs 1993 through 1997.

Savings From Inventory Management Initiatives

Subsistence Items. The Defense Personnel Support Center management estimated savings from adopting prime vendor practices in procuring subsistence items by measuring the reduction in inventory levels, excluding war reserves, at the wholesale level. The Defense Personnel Support Center managers noted three categories of savings: reductions in commercial cold storage warehouse costs under the Defense Personnel Support Center control; reductions in the DLA depot system surcharge, which is based on the DLA cost for staffing and managing warehouses; and reductions in inventory holding costs. In response to a General Accounting Office (GAO) request for data, the Defense Personnel Support Center was reviewing actual savings at the retail level. To collect the data, the Defense Personnel Support Center was using its internal review organization to identify economies and efficiencies at the retail level.

Department of the Army. The Army Tank-automotive and Armaments Command (TACOM) calculated DVD savings based on computer modeling. The model, developed in cooperation with the Army Materiel Command, included appropriate cost factors for calculating savings related to a specific item and the difference in cost between the depot stock method of managing inventory and DVD. The factors included inventory holding cost, lead time reductions, transportation and offsetting cost. The model was reasonable and calculated savings in accordance with DoD Regulation 4140.1-R.

The TACOM organized a team to improve the management of its \$67 million in annual procurements of tactical tires for the High Mobility Multi-Purpose Wheeled Vehicle and commercial tires for other wheeled vehicle programs. Searching for national stock numbers that are the best candidates for commercial practices, TACOM implemented DVD for \$36 million of its \$67 million in annual tire purchases. Before implementing DVD, TACOM ordered large quantities of tires at one time and stored those tires at numerous depots. By using DVD, TACOM reduced the quantity of tires stored in supply depots by 65 percent. As a result of that success, TACOM is now managing the supply of retreaded tires throughout the Army using DVD. The Army is also planning to implement a program that uses the Internet to order and purchase supplies at one of its depots by October 1998. That type of program uses the Internet information to identify the least expensive part available from commercial or Government sources and to arrange for DVD to the user.

Department of Navy. The Navy had not developed a specific model to compute and track cost savings applicable to DVD initiatives. Supply management officials in the Navy and the Marine Corps felt that tracking those savings added little value. The Navy gave inventory item managers the responsibility to determine the best practices for items that they managed. The managers analyzed alternative practices, such as DVD, based on expected reductions in cost from improved processing times, lower handling cost, and reduced inventory on hand. DoD Regulation 4140.1-R allowed the Navy the flexibility to calculate cost savings in this manner. Any Navy savings attributed to DVD were considered to be part of the overall reductions to the logistics budget because of lowered requirements.

Savings From Inventory Management Initiatives

The Navy has pursued DVD initiatives, for both consumable and repairable items, as part of its overall logistics planning. Inventory control points initiated contracts for transfer of inventory management and depot repair responsibility to contractors, direct delivery of communications and computer parts to the end user, and prime vendor contracts for facilities maintenance to Navy installations. The Navy also contracted with an accounting firm to review the viability of applying DVD initiatives to repairable items and to recommend strategies for the Navy inventory control points to pursue.

Department of the Air Force. The Air Force had not developed a specific model to compute and track cost savings applicable to DVD initiatives. The Air Force, with contractor assistance, projected a 6-year budget savings of \$798 million for the fiscal years 1997 through 2001 for all Lean Logistics initiatives. The contractor recomputed Air Force material requirements based on reduced times for various logistics functions. The reductions in cycle and shipping times were partly attributable to the use of DVD techniques, but savings could not be tracked to specific Lean Logistics initiatives. DoD Regulation 4140.1-R allows DoD organizations the flexibility to use differing practices in calculating savings. The contractors' estimates considered all relevant cost factors contained in the regulation.

The Air Force pursued DVD techniques as part of its overall Lean Logistics initiative. Lean Logistics is an approach to weapon system support that focuses on reducing the time required for spare parts to reach the end user. The Air Force has estimated that over several years, it could eliminate 1,672 personnel positions by streamlining maintenance and repair cycles and reducing shipping times from an average of 66 to 36 days. To further that effort, the Air Force Materiel Command is developing two new programs: the Depot Repair Enhancement Program, a demand-driven system that prioritizes requirements and speeds delivery of spare parts, and the Contract Repair Enhancement Program, which will implement commercial pricing and packaging and reduce Government oversight. In collaboration with the DLA, the Air Force has started to develop a DVD capability for consumable spare parts that would further reduce inventory costs.

DoD Management. Officials in the Office of the Deputy Under Secretary of Defense for Logistics, recognizing the diversity of logistics initiatives within the Military Departments, did not advocate the development and use of a uniform savings methodology. They maintain that DoD Regulation 4140.1-R adequately discusses the considerations needed for savings calculations. The regulation was revised based on recommendations contained in a Logistics Management Institute study, "Direct Shipment: An Approach for Reducing DoD Inventories," August 1990. The concept was to allow each organization to develop its own savings methodology to fit its unique requirements, as long as it included the considerations in DoD Regulation 4140.1-R. Our review showed that DoD logistics organizations were considering the factors discussed in the regulation in calculating cost savings.

DoD logistics officials also commented that with the downsizing of the logistics infrastructure, the resources needed to do elaborate savings calculations simply are not available, and if made available, would be reduced rapidly. Logistics

Savings From Inventory Management Initiatives

officials questioned the benefit that a new, uniform system for calculating savings would yield. They were also of the opinion that establishing a hierarchy within DoD organizations to calculate savings resulting from the adoption of best commercial inventory management practices could be overly restrictive and could stifle innovation.

Part II - Additional Information

Appendix A. Audit Process

Scope

We performed the program audit in the Office of the Secretary of Defense and at selected DoD organizations with responsibilities for managing storage of equipment and material for the Military Departments and other DoD organizations. Our review was limited to reviewing methods for calculating savings resulting from using best commercial inventory management practices. Within DoD, we visited the Offices of the Under Secretary Defense (Comptroller) and the Deputy Under Secretary Defense for Logistics. We also visited DLA and its component, the Defense Personnel Support Center. Within the Military Departments, we visited five inventory control points responsible for managing storage of equipment and material. We reviewed policies, procedures, and practices for estimating savings from DVD. We reviewed available documentation, such as computer reports and management analyses, supporting the calculations of savings from inventory reductions and reduced warehousing costs. The documentation covered the period from FYs 1993 through 1997. We did not review impediments to expanding the use of DVD, nor did we perform detailed testing of DVD program benefits because the benefits were widely documented.

Methodology

We judgmentally selected seven sites and organizations to visit and examined estimated savings reported from the implementation of commercial inventory management practices for the period FYs 1993 through 1997. At each site visited, we interviewed personnel to determine methodologies that they used to compute savings and analyzed the reasonableness of those methodologies. We used DoD Regulation 4140.1-R to evaluate the reasonableness of savings methodologies. The Quantitative Methods Division, Office of the Assistant Inspector General for Auditing, Inspector General, DoD, helped us assess the reasonableness of computer-processed savings methodologies. The Quantitative Methods Division reviewed the computer models to determine the reasonableness of the underlying calculations and assumptions of the models.

Audit Period and Standards. We conducted this program audit from February through May 1997 in accordance with auditing standards issued by the

Comptroller General of the United States, as implemented by the Inspector General, DoD. We did not test management controls because the savings methodologies employed did not directly affect financial records, asset controls, or accountability. We did not rely on computer-processed data, and our use of computer-processed information was limited to reviewing the underlying programming instructions.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD and GAO. Further details are available on request.

Appendix B. Prior Audits and Other Reviews

Since June 1993, the benefits of DVD inventory practices have been the subject of five GAO reports; one Inspector General, DoD, report; and one Air Force Audit Agency report. We have summarized the reports below.

GAO Report No. NSIAD-97-82. This report, OSD Case No. 1293, "The Army Could Reduce Logistics Costs for Aviation Parts by Adopting Best Practices," April 15, 1997, reports that the Army could enhance its efforts to improve its logistics pipeline for aviation parts and reduce logistics costs by incorporating best practices from the private sector. The current repair pipeline of the Army, characterized by a \$2.6 billion investment in aviation parts, is slow and inefficient. Because of the lengthy pipeline time, the Army buys, stores, and repairs more parts than would be necessary with a more efficient system. Best practices used in the airline industry provide opportunities to build on the efforts of the Army to improve its logistics pipeline. Best commercial inventory management practices included third party logistics services, eliminating excess inventory, cellular manufacturing techniques, and innovative supplier partnerships. DoD agreed with the findings and recommendations and indicated that the Army is participating in the DLA Virtual Prime Vendor pilot program.

GAO Report No. NSIAD-96-156. This report, OSD Case No. 1142, "Inventory Management: Adopting Best Practices Could Enhance Navy Efforts to Achieve Efficiencies and Savings," July 12, 1996, focuses on the Navy logistics system for aircraft parts. The report states that the Navy is working to improve its logistics systems and that best practices identified in the airline industry have the potential for use in the Navy system. The report recommended that the Navy, in coordination with DLA, develop a demonstration project to test specific practices highlighted in the report. Management concurred with the finding and its related recommendations.

GAO Report No. NSIAD-96-5. This report, OSD Case No. 1047, "Best Management Practices: Reengineering the Air Force's Logistics System Can Yield Substantial Savings," February 21, 1996, compares the Air Force management of its \$33 billion repairable parts inventory with the operations of leading-edge private sector firms to identify opportunities in which costs could be reduced and service improved. The report recognizes that the Air Force has begun a reengineering program aimed at redesigning its logistics operations. However, several major barriers to bringing about change must be addressed and resolved if the Air Force is to reengineer its logistics system and save billions of dollars.

The success of the Air Force in achieving a "Quantum Leap" in system improvements hinges on its ability to address and overcome certain barriers such

as inherent organizational resistance to change. Also, information systems do not always provide Air Force managers and employees with accurate, real time data on elements that are required to successfully plan, control, and measure inventory management operations. The DoD generally agreed with the findings and recommendations in the report. The DoD stated that the Air Force Lean Logistics program should receive top-level DoD support in achieving its goals.

GAO Report No. NSIAD-95-142. This report, OSD Case No. 9919, "Inventory Management: DoD Can Build on Progress in Using Best Practices to Achieve Substantial Savings," August 4, 1995, states that the DoD large inventory levels reflect its management practice of buying and storing supplies at both wholesale and retail locations to ensure availability, sometimes years in advance of actual need. Storing inventory at many different locations results in low turnover, which produces large amounts of old, obsolete, and excess items. In the private sector, many companies that are using the most aggressive practices no longer store inventory in intermediate locations; the suppliers deliver inventory as needed. The report recommended that DoD test applicability of using similar types of private sector practices as an alternative to its current multilayered system. DoD generally agreed with the findings, conclusions, and recommendations and stated that additional steps are underway in adopting the best commercial inventory management practices in both personal and hardware items.

GAO Report No. NSIAD-94-64. This report, OSD Case No. 9579, "Commercial Practices and Leading Edge Practices Can Help DoD Better Manage Clothing and Textile Stocks," April 13, 1994, compares the DoD inventory management system for supplying clothing and textile items to that of the Services, valued at \$1.8 billion. Specifically, the report addresses inventory problems and other inefficiencies in DLA; commercial practices used in the private sector to reduce inventory holding and distribution costs; and DoD progress in improving clothing and textile inventory management. DoD was continuing to store redundant levels of clothing and textile inventories throughout its wholesale and retail system. To maintain stocks, DoD employs a large supply operations infrastructure and, in doing so, often incurs unnecessary inventory handling and storage costs. Many private sector firms and some Federal agencies with uniformed employees are relying on prime vendors to manage their clothing inventories. The report recommended that DoD conduct a pilot project to demonstrate whether the prime vendor concept is beneficial in providing high usage uniform items, such as items that are a part of the Defense Personnel Support Center, to military recruit induction centers. DoD generally agreed with the findings and recommendations, but stated that the report should give greater recognition to the initiatives of DoD to use commercial inventory management practices. Prime vendor arrangements have been tested for difficult-to-obtain clothing and textile items. DoD believes that the results of

Appendix B. Prior Audits and Other Reviews

those tests should be evaluated before expanding the concept to high-volume items. DoD stated that the evaluation should include an assessment of costs, benefits, and the impact on readiness.

Inspector General, DoD, Report No. 96-109. This report, "Prime Vendor Support of Medical Supplies," May 7, 1996, states that the Defense Personnel Support Center; the Surgeons General of the Army, the Navy, and the Air Force; and participating medical treatment facilities have successfully implemented a Prime Vendor Program that mirrors the commercial business practices for the purchase of medical supplies. The major benefits of the Prime Vendor Program were reduced inventory, increased customer satisfaction, and reduced materiel prices. Because the report contains no findings or recommendations, written comments were not required, and none were received.

Air Force Audit Agency Report No. 94051011. This report, "Review of the Medical Prime Vendor Contracting Program," October 31, 1995, states that the Air Force implemented the medical Prime Vendor Program in a generally effective manner. However, medical treatment facilities could realize further inventory reductions in both medical supply warehouses and pharmacies. The Air Force Audit Agency recommended that the Surgeon General of the Air Force establish a policy that requires medical treatment facilities to minimize investment in inventory and require specific justification for maintaining a warehouse inventory for pharmaceutical items purchased from the prime vendor. Additionally, it recommended that pharmacies reduce their stockage objectives for prime vendor items to 5 days. Management generally agreed with the findings, conclusions, and recommendations and stated that it would eliminate or minimize all pharmaceutical products in the warehouse and minimize pharmacy inventory for items that are procured from the prime vendor; however, the final decision should remain with the local organization.

Appendix C. Report Distribution

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Commander, Army Materiel Command

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Deputy Chief of Naval Operations (Logistics)
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Department of the Air Force

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House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight
House Committee on National Security

Audit Team Members

The Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD, managed this joint audit. The following personnel contributed to this report.

Shelton R. Young
John A. Gannon
Walter R. Loder
Joseph A. Powell
Henry Y. Adu
Martha M. Mitchel (Army Audit Agency)
Albert D. Enslin (Naval Audit Service)
William T. Hubbard (Air Force Audit Agency)

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Arlington, VA 22202-2884

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